Company	Average Price	Annual Dividend	I/B/E/S Mean Growth	Cost Of Equity
Albertsons Inc	29.63	0.760	11.4%	14.44%
Abbott Laboratories	46.12	0.760	12.4%	14.36%
Archer-Daniels-Midland Co	14.03	0.200	11.8%	13.49%
Automatic Data Processing	54.14	0.410	15.1%	16.02%
Aetna Inc	35.56	0.800	12.7%	15.39%
American Home Products Corp	57.40	0.920	13.5%	15.43%
American Greetings	12.53	0.400	9.5%	13.23%
Air Products & Chemicals Inc	39.93	0.760	11.1%	13.34%
Allegheny Technologies Inc	17.80	0.800	10.6%	15.93%
Avon Products	40.70	0.740	12.4%	14.57%
Avery Dennison Corp	52.78	1.200	12.8%	15.52%
Baxter International Inc	90.11	1.164	13.5%	15.05%
Brunswick Corp	21.06	0.500	12.8%	15.65%
Bard (C.R.) Inc	43.53	0.840	12.2%	14.50%
Black & Decker Corp	40.14	0.480	14.5%	15.95%
Becton Dickinson & Co	33.73	0.380	12.2%	13.54%
BellSouth Corp	39.48	0.760	11.9%	14.18%
Biomet Inc	39.38	0.107	15.0%	15.33%
Bemis Co	33.67	0.960	11.4%	14.78%
Bristol Myers Squibb	57.65	0.980	12.5%	14.53%
Computer Associates Intl Inc	27.64	0.080	15.7%	16.05%
Conagra Foods Inc	18.75	0.900	9.8%	15.46%
Caterpillar Inc	44.08	1.360	9.8%	13.41%
Cooper Industries Inc	39.23	1.400	10.3%	14.50%
Carnival Corp	28.50	0.420	14.0%	15.78%
Cigna Corp	107.60	1.240	13.2%	14.58%
Colgate-Palmolive Co	54.40	0.630	12.5%	13.88%
Clorox Co/De	33.05	0.840	11.9%	14.92%
Cooper Tire & Rubber	12.80	0.420	10.3%	14.16%
CenturyTel Inc	27.68	0.190	13.6%	14.42%
Centex Corp	40.48	0.160	13.0%	13.47%
Disney (Walt) Company	28.53	0.210	14.6%	15.49%
Dow Jones & Co Inc	56.20	1.000	11.1%	13.20%
Deluxe Corp	23.24	1.480	6.7%	14.04%
Donnelley (R R) & Sons Co	27.52	0.920	11.6%	15.58%
Darden Restaurants Inc	22.83	0.080	14.9%	15.32%
Engelhard Corp	25.18	0.400	12.6%	14.50%
Ecolab Inc	40.98	0.520	14.0%	15.53%
Eastman Kodak Co	42.72	1.760	8.5%	13.28%
Emerson Electric Co	64.48	1.530	12.6%	15.44%
EOG Resources Inc	45.00	0.140	14.4%	14.78%
Eaton Corp	69.89	1.760	10.5%	13.46%
First Data Corp	58.90	0.080	14.5%	14.66%
Fortune Brands Inc	32.63	0.960	11.6%	15.10%
Sprint FON Group	21.77	0.500	12.3%	15.04%
Gillette Co	31.71	0.650	11.6%	14.03%
Gannett Co	60.68	0.880	12.0%	13.72%
General Mills Inc	43.55	1.100	10.7%	13.67%
Genuine Parts Co	25.84	1.140	8.2%	13.31%
Goodrich (B F) Co	38.40	1.100	12.1%	15.52%
Goodyear Tire & Rubber Co	25.10	1.200	9.6%	15.22%

Company	Average Price	Annual Dividend	I/B/E/S Mean Growth	Cost Of Equity
Grainger (W W) Inc	33.51	0.680	12.3%	14.72%
Harcourt General Inc	55.85	0.840	14.3%	16.12%
HCA-Healthcare Co	37.15	0.080	14.9%	15.16%
Hilton Hotels Corp	10.90	0.080	12.5%	13.37%
Heinz (H J) Co	40.29	1.570	9.2%	13.75%
Honeywell International Inc	40.99	0.750	13.9%	16.11%
Hewlett-Packard Co	30.30	0.320	14.3%	15.58%
Intl Business Machines Corp	98.03	0.520	13.2%	13.83%
ITT Industries Inc	39.61	0.600	13.9%	15.73%
Illinois Tool Works	61.15	0.800	12.9%	14.46%
Johnson Controls Inc	64.59	1.240	13.6%	15.91%
Johnson & Johnson	90.18	1.280	12.9%	14.60%
Nordstrom Inc	17.03	0.360	13.0%	15.54%
Kimberly-Clark Corp	68.11	1.080	11.3%	13.17%
Kerr-McGee Corp	66.75	1.800	11.8%	15.01%
Coca-Cola Co	48.83	0.680	13.0%	14.67%
Leggett & Platt Inc	19.65	0.440	12.7%	15.38%
Liz Claiborne Inc	46.86	0.450	12.3%	13.44%
Lilly (Eli) & Co	75.20	1.120	13.2%	14.99%
Lockheed Martin Corp	35.55	0.440	11.9%	13.37%
May Department Stores Co	37.83	0.930	10.6%	13.49%
McGraw-Hill Companies	57.65	0.940	13.1%	15.05%
Minnesota Mining & Mfg Co	109.13	2.320	11.4%	13.91%
Molex Inc	37.25	0.100	14.9%	15.23%
Merck & Co	73.52	1.360	11.9%	14.10%
USX-Marathon Group	27.92	0.920	10.1%	13.97%
Maytag Corp	34.00	0.720	13.3%	15.85%
Nucor Corp	43.58	0.600	14.3%	15.97%
New York Times Co	42.20	0.460	12.5%	13.80%
Pitney Bowes Inc	34.70	1.160	11.9%	15.89%
Pepsico Inc	43.68	0.560	13.3%	14.84%
Procter & Gamble Co	65.33	1.400	11.4%	13.93%
Parker-Hannifin Corp	41.81	0.720	11.6%	13.64%
Rohm & Haas Co	34.24	0.800	11.6%	14.37%
Rockwell Intl Corp	42.38	1.020	11.0%	13.84%
Raytheon Co -Cl B	29.02	0.800	10.8%	14.05%
Sears Roebuck & Co	36.88	0.920	10.3%	13.22%
SBC Communications Inc	43.88	1.015	13.3%	16.08%
Schering-Plough	36.98	0.560	13.7%	15.52%
Sherwin-Williams Co	25.49	0.540	11.0%	13.50%
Snap-On Inc	29.28	0.960	10.1%	13.95%
Supervalu Inc	13.38	0.550	11.0%	15.88%
Stanley Works	34.62	0.920	11.7%	14.86%
Target Corp	36.08	0.220	15.1%	15.84%
Tosco Corp	42.02	0.320	12.7%	13.61%
Tribune Co	39.17	0.440	13.1%	14.44%
TRW Inc	36.90	1.400	9.6%	14.04%
Tupperware Corp	23.95	0.880	11.8%	16.19%
Texaco Inc	66.94	1.800	10.7%	13.87%
Textron Inc	55.62	1.300	13.1%	15.91%
United Technologies Corp	73.70	0.900	13.8%	15.27%
VF Corp	34.96	0.920	11.2%	14.31%

Company	Average Price	Annual Dividend	I/B/E/S Mean Growth	Cost Of Equity
Verizon Communications	47.15	1.540	11.6%	15.49%
Wendy's International Inc	22.78	0.240	14.1%	15.37%
Whirlpool Corp	52.44	1.360	11.4%	14.47%
Waste Management Inc	25.70	0.010	14.2%	14.25%
Wal-Mart Stores	48.55	0.240	14.5%	15.10%
USX-U S Steel Group	15.68	1.000	8.1%	15.54%
Market Weighted Average				14.75%

Source: Standard & Poor's Compustat Database. Price is average of March 2001 high and low prices. Quarterly dividend obtained from the annual dividend rate as reported by Compustat, divided by 4. I/B/E/S growth rate is the mean estimate of the long-term growth rate as reported by Compustat.

Notes: In applying the DCF Model to the S&P Industrials, I included in the DCF analysis only those companies in the S&P Industrial group which have a reported stock price, pay a dividend, have a positive growth rate, have at least three analysts' long-term growth estimates, and have at least one common share outstanding. To be conservative, I also eliminated those 25 percent of companies with the highest and lowest DCF results, those companies with cost of equity results equal to or below the March 2001 average yield on Moody's A-rated industrial bonds or equal to or above 20 percent. The weighted average DCF result for all four quartiles of the S&P Industrials was 15.01 percent, while the weighted average DCF result for 2nd and 3rd quartiles shown here on Schedule JVW-1 is 14.75 percent. Elimination of the 1st and 4th quartiles of the S&P Industrials had a negligible effect on the market value capital structure.

Notation:

d_0	=	Quarterly Dividend (indicated annual dividend divided by 4).
P_0	=	Average of the monthly high and low stock prices March 2001.
FC	=	Flotation costs expressed as a percent of gross proceeds (5 percent).
g	=	I/B/E/S mean forecast of future earnings growth.
k	=	Cost of equity using the quarterly version of the DCF Model as shown by the formula below:

$$k = \left[\frac{d_0 (1+g)^{\frac{1}{4}}}{P_0} + (1+g)^{1/4} \right]^4 - 1$$

[redacted]

B

[redacted]

Company	Average Price	Annual Dividend	I/B/E/S Mean Growth	Cost of Equity
ALLTEL	52.69	1.320	13.8%	16.83%
BellSouth	39.48	0.760	11.9%	14.18%
SBC Communications	43.88	1.015	13.3%	16.08%
Verizon Communications	47.15	1.540	11.6%	15.49%
Market Weighted Average				15.52%

Source: Standard & Poor's Compustat Database. Price is average of March 2001 high and low prices. Quarterly dividend obtained from the annual dividend rate as reported by Compustat , divided by 4. I/B/E/S growth rate is the mean estimate of the long-term growth rate as reported by Compustat.

Notation:

d_0	=	Quarterly Dividend (indicated annual dividend divided by 4).
P_0	=	Average of the monthly high and low stock prices March 2001.
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g	=	I/B/E/S mean forecast of future earnings growth.
k	=	Cost of equity using the quarterly version of the DCF Model as shown by the formula below:

$$k = \left[\frac{d_0 (1+g)^{\frac{1}{4}}}{P_0} + (1+g)^{1/4} \right]^4 - 1$$

C

JAMES H. VANDER WEIDE, Ph.D.
3606 Stoneybrook Drive
Durham, NC 27705
Tel. 919.383.6659 or 919.383.1057
jim.vanderweide@duke.edu

James H. Vander Weide is Research Professor of Finance and Economics at the Fuqua School of Business, Duke University. Dr. Vander Weide is also founder and President of Financial Strategy Associates, a consulting firm that provides strategic, financial, and economic consulting services, including cost of capital and valuation studies.

Educational Background and Prior Academic Experience

Dr. Vander Weide holds a Ph.D. in Finance from Northwestern University and a Bachelor of Arts from Cornell University. In January 1972, he joined the faculty of the School of Business at Duke University and was named Assistant Professor, Associate Professor, and then Professor. In 1982, he assumed the position of Associate Dean of Faculty Affairs at the Fuqua School. He resigned this position in July 1983 and is now Research Professor of Finance and Economics.

Since joining the faculty at Duke University, Dr. Vander Weide has taught courses in corporate finance, investment management, and management of financial institutions. He has also taught courses in statistics, economics, and operations research, and a Ph.D. seminar on the theory of public utility pricing. Dr. Vander Weide has also been active in executive education at Duke. Dr. Vander Weide helped design the Duke Advanced Management Program at the Fuqua School of Business and served as Program Director for this program for five years. Dr. Vander Weide now serves as Program Director and teacher in many executive programs designed to prepare managers for the competitive environment in American industry.

Publications

Dr. Vander Weide has written a book entitled *Managing Corporate Liquidity: An Introduction to Working Capital Management* published by John Wiley and Sons, Inc. He has

also written a chapter titled, "Financial Management in the Short Run" for *The Handbook of Modern Finance*, and written research papers on such topics as portfolio management, capital budgeting, investments, the effect of regulation on the performance of public utilities, and cash management. His articles have been published in *American Economic Review, Financial Management, International Journal of Industrial Organization, Journal of Finance, Journal of Financial and Quantitative Analysis, Journal of Bank Research, Journal of Portfolio Management, Journal of Accounting Research, Journal of Cash Management, Management Science, Atlantic Economic Journal, Journal of Economics and Business,* and *Computers and Operations Research.*

Professional Consulting Experience

Dr. Vander Weide has provided financial and economic consulting services to firms in the electric, gas, insurance, telecommunications, and water industries for more than 20 years. He has testified on the cost of capital, competition, risk, incentive regulation, forward-looking economic cost, economic pricing guidelines, depreciation, accounting, valuation, and other financial and economic issues in some 300 cases before the U.S. Congress, the Canadian Radio-Television and Telecommunications Commission, the Federal Communications Commission, the National Telecommunications and Information Administration, the Federal Energy Regulatory Commission, the public service commissions of 39 states, and the insurance commissions of five states. With respect to implementation of the Telecommunications Act of 1996, Dr. Vander Weide has testified in 26 states on issues relating to the pricing of unbundled network elements and universal service cost studies and has consulted with Bell Canada, Deutsche Telekom, and Telefónica on similar issues. He has also provided expert testimony on issues related to electric and natural gas restructuring. He has worked for Bell Canada on a special task force to study the effects of vertical integration in the Canadian telephone industry

and has worked for Bell Canada as an expert witness on the cost of capital. Dr. Vander Weide has provided consulting and expert witness testimony to the following companies:

Telecommunications Companies

ALLTEL and its subsidiaries
AT&T
Bell Canada
Centel and its subsidiaries
Citizens Telephone Company
Contel and its subsidiaries
Deutsche Telekom
Heins Telephone Company
NYNEX and its subsidiaries (now Verizon)
Roseville Telephone Company
Southern New England Telephone
The Stentor Companies
Union Telephone Company
Woodbury Telephone Company
Ameritech
Bell Atlantic and subsidiaries (Verizon)
BellSouth and its subsidiaries
Cincinnati Bell (Broadwing)
Concord Telephone Company
GTE and subsidiaries (now Verizon)
Minnesota Independent Equal Access Corp.
Pacific Telesis and its subsidiaries
SBC Communications
Sherburne Telephone Company
Sprint/United and its subsidiaries
Telefónica
U S West (now Qwest)

Water, Electric and Gas

American Water Works
CP&L (Progress Energy)
Central Illinois Public Service
Citizens Utilities
Consolidated Natural Gas and its subsidiaries
Interstate Power Company
Iowa-Illinois Gas and Electric
Iowa Southern
Kentucky Power Company
MidAmerican Energy and its subsidiaries
Nevada Power Company
NICOR
North Carolina Natural Gas
North Shore Gas
PacifiCorp
PG&E
Peoples Energy and its subsidiaries
The Peoples Gas, Light and Coke Co.
Public Service Company of North Carolina
PSE&G
Sempra Energy
South Carolina Electric and Gas
Southern Company
United Cities Gas Company

Insurance Companies

Allstate
North Carolina Rate Bureau
United Services Automobile Association (USAA)
The Travelers Indemnity Company

Other Professional Experience

Dr. Vander Weide conducts in-house seminars and training sessions on topics such as financial analysis, competitive strategy, financial strategy, capital budgeting, cost of capital, cash

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Expedited Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration	)	CC Docket No. 00-218
In the Matter of Petition of Cox Virginia Telecom, Inc., etc.	)	CC Docket No. 00-249
In the Matter of Petition of AT&T Communications of Virginia Inc., etc.	)	CC Docket No. 00-251

VERIZON VIRGINIA INC.

Testimony of Dr. John Lacey

July 31, 2001

VERIZON VIRGINIA INC.

DIRECT TESTIMONY OF DR. JOHN M. LACEY

CC DOCKET NOS. 00-218, 00-249, 00-251

JULY 31, 2001

TABLE OF CONTENTS

I. INTRODUCTION
(JDPL Issues II-1-a; II-1-c; II-2-a; II-2-c)

Q. What is your name and address?

A. My name is Dr. John M. Lacey. I am Professor of Accountancy and Ernst & Young Research Fellow at California State University, Long Beach. My address is 7 Poppy Trail, Rolling Hills, CA 90274.

Q. Please describe your educational background and academic and professional experience.

A. I earned my Ph.D. at UCLA, with a major in accounting information systems and minors in economics and mathematics. I earned an MBA with a major in quantitative business analysis and a Bachelor of Science in accounting at the University of Southern California (USC). I previously taught at the Leventhal School of Accounting at USC and at the Anderson Graduate School of Management at UCLA. While at USC, I served on the Telecommunications MBA Program faculty and taught in the Telecommunications Executive Program. I am a CPA.

I have served on the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA) and chaired its Participating Mortgages Task Force and International Accounting Standards Task Force. I also served as Chair of the AICPA Real Estate Committee and its Accounting and Auditing Guide Task Force. I currently serve on the AICPA Continuing Professional Education Committee, chair the California Society of

CPA's Accounting Principles and Auditing Standards Committee and serve on a task force of the Independence Standards Board.

I regularly teach accounting to federal and state judges through the Federal Judicial Center, the National Judicial College, and state judiciary organizations. I also teach regularly for two large banks, a large investment company, and the Los Angeles Society of Financial Analysts. I am the author of a research study on auditor independence commissioned by the Chief Accountant of the Securities & Exchange Commission. I have published books and articles in academic and professional journals. Prior to beginning my academic career, I was a supervisor in the national office of a major CPA firm and was controller of a manufacturing company.

Q. Do you have particular experience with respect to accounting standards and practices relating to depreciation lives?

A. Yes. I served on the Accounting Standards Executive Committee (AcSEC), AICPA's senior accounting standards committee. In that capacity, I voted on the establishment and revision of Generally Accepted Accounting Principles ("GAAP") that must be followed by all companies whose financial statements are accompanied by a CPA's report. As discussed more fully below, GAAP includes the guidelines for determining the lives used to depreciate capital assets. As Chairman of the AICPA Real Estate Committee, I was responsible for drafting proposed accounting standards relating to the depreciation of assets on both a historical cost and current value basis. I was also responsible for establishing

depreciation lives for assets at the manufacturing company at which I was the controller.

Q. Have you previously testified on accounting, financial, or economic issues?

A. Yes. I have testified about accounting, financial, and economic issues in the Federal Court of Claims, in other federal courts, and in federal and state administrative proceedings.

Q. What is the purpose of your testimony?

A. Verizon Virginia Inc. ("Verizon VA") has asked me to make an independent appraisal of whether (1) depreciable lives determined under GAAP should be used in forward-looking cost studies; (2) Verizon VA's proposed depreciation lives are consistent with GAAP; and (3) the 1993 and 1994 regulatory prescribed lives are appropriate for use in this proceeding.

Q. Please summarize your direct testimony.

A. As Mr. Sovereign explains, Verizon VA's proposed depreciation lives and net salvages were prepared in accordance with GAAP and reflect the economic lives of network assets. In my opinion, a forward-looking cost study should use depreciation lives that are based on GAAP instead of regulatory prescribed lives because GAAP lives better reflect all information known to the company, including the effects of competition and technological changes. Indeed, Verizon VA's use of GAAP lives in this proceeding is conservative because it experiences unique risks associated with providing UNEs to CLECs — risks not faced by

other carriers. For example, competitors may use Verizon VA's UNEs for only a short period and then use their own facilities, leaving Verizon VA with undepreciated costs to be written off as a loss, resulting in stranded facilities.

Verizon VA's cost studies in this proceeding, moreover, appropriately follow GAAP and are more appropriate than the lives prescribed for regulatory purposes in 1993 and 1994 prior to the Telecommunications Act.

II. A FORWARD-LOOKING COST STUDY SHOULD USE GAAP LIVES TO DEPRECIATE ASSETS. (JDPL Issues II-1-a; II-1-c; II-2-a; II-2-c)

Q. Please explain how GAAP depreciable lives are determined.

A. GAAP depreciable lives are based upon the expected life during which the assets will produce economic benefits to the company. The goal is to allocate as equitably as possible the cost of using the depreciable asset over the period during which the company obtains economic benefits from the asset.

Q. Are GAAP lives forward-looking?

A. Yes. GAAP lives are forward-looking because they are based upon the expected period of future economic benefit to the company. The initial assessment of useful life is made based upon the period of time during which the asset will produce economic benefits to the company from the date of acquisition. The remaining useful life of the asset is reassessed as financial reports are released to reflect events as they occur and circumstances as they change. Thus, GAAP lives are, by their very nature, forward-looking.

Q. How are capital expenditures initially recorded and depreciated under GAAP?

A. The process is described in Financial Accounting Standards Board (FASB) Concept Statement 6. The FASB is the preeminent accounting standard-setting body in the United States. The Statements of Financial Accounting Concepts published by this organization set forth the objectives and fundamentals that are the basis for accounting and reporting standards in the United States.

A capital expenditure is initially recorded as an asset and then is charged to expense as its future economic benefits expire.[1] Upon acquisition, the expenditure is recorded as an asset in the amount of the acquisition cost. At the same time, the useful life to the company and the residual value expected upon disposition (positive or negative) is initially assessed. The process of allocating the cost of using the asset (the difference between the acquisition cost and residual value expected upon disposition) over its useful life also begins upon acquisition. The process results in a systematic and rational allocation of the cost

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[1] FASB Concept Statement No. 6, "Elements of Financial Statements," describes the process in paragraph 149 as follows:

> [M]any assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the period over which they are expected to provide benefits) by a "systematic and rational" allocation procedure, for example, by recognizing depreciation or other amortization.

The process is also described in FASB Concept Statement 5, "Recognition and Measurement in Financial Statements of Business Enterprises," at paragraph 86c where it states,

> Some expenses, such as depreciation and insurance, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.

of using the asset as a charge to the company's operating income over the time it produces economic benefits to the company.

Q. Please explain economic depreciation.

A. Economic depreciation is the change in value of a depreciable asset during the period.

Q. Is the useful life for computing economic depreciation consistent with the life used to compute depreciation under GAAP?

A. Yes. Both GAAP depreciable life and economic depreciable life reflect the period during which an asset is expected to provide future economic benefits.[2]

Q. Has this Commission addressed the use of depreciation in TELRIC cost studies?

A. Yes. This Commission addressed the concept of depreciation in the *Local Competition Order*:

> We conclude that an appropriate calculation of TELRIC will include a depreciation rate that reflects the *true changes in economic value of an asset* and a cost of capital that appropriately reflects the risks incurred by an investor.[3]

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[2] *See, e.g.*, Carlton, Dennis and Perloff, Jeffrey M., *Modern Industrial Organization*, Addison Wesley, at 35.

[3] First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, ¶ 703 (Aug. 8, 1996) (emphasis added).

This Commission further stated:

> Depreciation is the method of recognizing as an expense the cost of a capital investment. Properly calculated economic depreciation is a periodic reduction in the *book value of an asset that makes the book value equal to its economic or market value.*[4]

The true change in the economic value of the asset is dependent upon the economic benefits flowing from the asset. These economic benefits will, of course, be affected by competition and technological changes, which shorten the economic life of an asset. Mr. Harold West III further discusses in his testimony the state of competition in Virginia.

Q. Are the economic depreciation lives and the lives used to compute depreciation expense under GAAP consistent with the Commission's rules?

A. Yes. Economic and GAAP depreciation lives reflect the forward-looking period during which the asset produces economic benefits to the company. Both concepts are designed to write the asset down from acquisition cost to the net residual value over the course of the asset's depreciable life. In fact, the use of GAAP lives is conservative because GAAP lives do not take into account the added risk inherent for those specific UNEs provided to CLECs.

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[4] *Id.* at n.1711.

Q. What would happen to depreciation lives if Verizon VA replaced its entire network simultaneously?

A. Depreciation lives would be drastically shorter than current GAAP or economic lives. The depreciable life of the network would be the time from the initial installation of the new system until its expected instantaneous replacement with the new system. During that time, the asset would be written down to its salvage value. The salvage value would be the net salvage expected upon retirement of the new system and implementation of the next instantaneous replacement. Thus, if an instantaneous replacement is assumed every study period, the depreciable life is equal to that study period and the salvage value is the net salvage value of the system at the end of that period. For example, using a three year study period, depreciation expense each year would be one third of the cost of the new system (net of any salvage value expected at the end of its three-year life).

III. VERIZON VA'S PROPOSED DEPRECIATION LIVES ARE RELIABLE, UNBIASED, AND CONSISTENT WITH GAAP. (JDPL Issues II-1-a; II-1-c; II-2-a; II-2-c)

A. Effect Of Depreciation On Financial Statements.

Q. Verizon VA has proposed in this proceeding the depreciation lives reflected in its financial statements, prepared in accordance with GAAP. For whom are the financial statements prepared?

A. Financial statements prepared in accordance with GAAP are general-purpose

financial statements meant to meet the needs of external users, including investors, creditors, and others.[5] Other users include rating agencies, employees, labor unions, and government agencies, including regulatory authorities.[6]

Q. What is included in Verizon VA's financial statements?

A. The financial statements, on which the auditors opine, include the following: (1) an income statement that reports on the results of operations for the period; (2) the balance sheet that reports the financial position at a specified date; (3) a statement of cash flows that reports on the sources and uses of cash for the period presented; and (4) the notes to the financial statements.

Q. Where is depreciation reflected in the financial statements?

A. Depreciation is an integral part of the computation of net income on the income statement and total assets on the balance sheet. The owners' equity on the balance sheet is also affected directly by depreciation, both because net income becomes part of owners' equity and because owners' equity is the difference between assets and liabilities. Also, the statement of cash flows usually discloses the amount of depreciation expense. The depreciation method, depreciable lives, and additional disclosures about depreciation are also included in the notes to the financial statements.

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[5] FASB Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," ¶ 28.

[6] *Id.* at ¶ 24.

Q. What accounting theory underlies the determination of GAAP depreciable life and depreciation computation?

A. The principal accounting theory underlying the determination of GAAP depreciable life and the depreciation computation is the "matching principle." Matching is the inclusion of revenue and the related expenses in the same time period for purposes of computing net income. Accrual accounting uses allocation procedures to relate revenues, expenses, gains, and losses to periods to reflect the company's performance, instead of just listing cash receipts and outlays in those periods.[7] The goal of accrual accounting is to account for events and transactions in the period in which they occur. Concept Statement 6 provides:

> Thus, recognition of revenues, expenses, gains, and losses and the related increments or decrements in assets and liabilities – including matching of costs and revenues, allocation, and amortization – is the essence of using accrual accounting to measure performance of entities.[8]

Matching is defined in that same concept statement:

> Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events....[9]

FASB Concept Statement 6 identifies matching as crucial to the measurement of income. Depreciation in turn involves matching the cost of using a long-lived asset to the periods of benefit. Because depreciable assets yield their benefits to a company over many periods, the expense from their use is allocated to the periods

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7 FASB Concept Statement 6, "Elements of Financial Statements," ¶ 145.

8 *Id.*

9 *Id.* ¶ 146.

during which they are expected to provide economic benefits to the company by a "systematic and rational" allocation procedure.[10] The amount allocated to each period is "depreciation expense."

In short, the period during which the asset is expected to provide economic benefits is the GAAP depreciable life. The longer the depreciable life of an asset, the smaller the depreciation expense per period.

Q. Is the accounting information in GAAP financial statements intended to be unbiased?

A. Yes, the accounting information used in GAAP financial statements is intended to be unbiased. FASB Statement of Financial Accounting Concept No. 2 includes "relevance" and "reliability" as the two primary decision-specific qualities accounting information must possess in order for the information to be useful to users of financial statements.[11]

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[10] *Id.* Paragraph 148 provides:

> However, many assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a "systematic and rational" allocation procedure, for example by recognizing depreciation or other amortization. Although the purpose of expense allocation is the same as that of other expense recognition – to reflect the using up of assets as a result of transactions or other events or circumstances affecting an entity – allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured.

[11] FASB Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," Figure 1.

This concept statement further defines these two primary decision-specific qualities. For example, for the information to be reliable, it must be verifiable, neutral, and faithful.

The accounting concept of neutrality is, in turn, defined in the glossary to FASB Concept Statement 2 as:

> Absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior.

This concept of neutrality must be followed in determining GAAP depreciable lives for depreciable assets. The determination of the GAAP depreciable lives should therefore be unbiased.

Q. Does Verizon VA have the incentive to report lives that are unreasonably short in its financial statements?

A. No. Verizon has no incentive to establish unreasonably short lives. As explained above, these lives are used to compute depreciation expense in Verizon VA financial statements prepared for investors and creditors. Short depreciation lives mean higher expenses and lower net income. Reporting lower net income could have negative implications for the company's stock price, the interest rate it pays for borrowing, and its ability to meet the increasingly important earnings expectations of investors.

Net income, moreover, is an important factor considered as part of management performance and has a direct (where management salary or bonus is dependent on earnings) and indirect (through stock option compensation and overall management reputation) effect on management compensation. Thus, the

use of biased, shorter depreciable lives would have negative implications for managers' compensation.

In short, Verizon has the economic incentive to use realistic and reasonable depreciable lives in its financial statements.

B. VERIZON VA'S PROPOSED DEPRECIATION LIVES ARE CONSISTENT WITH GAAP AND HAVE BEEN AUDITED BY AN INDEPENDENT AUDITOR.

Q. Does Verizon use GAAP lives in its annual report?

A. Yes. Verizon uses GAAP lives in its annual report to shareholders.

Q. Are the GAAP depreciable lives used by Verizon in its annual report the same lives used in its filings with the United States Securities & Exchange Commission?

A. Yes. The financial statements Verizon files with the United States Securities & Exchange Commission (SEC) must be in conformity with GAAP. Verizon uses the same GAAP depreciable lives in its annual report to shareholders that it does in its filings with the SEC.

Q. What factors did Verizon VA consider in establishing its GAAP depreciable lives?

A. As Mr. Sovereign explains, Verizon VA considered the decline in its depreciable assets' value due to factors such as competition, technological change, and the inherent risk in providing UNEs. Mr. West address in detail the state of

competition in Virginia and the risks facing Verizon VA. Consideration of these factors is consistent with the forward-looking principles of GAAP.

Verizon VA also considered the National Association of Regulatory Utility Commissioners' (NARUC) description of factors that cause property to be retired.[12] These factors include physical factors, functional factors, and contingent factors. As Mr. Sovereign explains, Verizon VA used the NARUC factors as a guideline in determining its GAAP lives, but paid particular attention to the functional factors that consider technology and competition when determining lives for the technology-driven accounts. Due to the rapid pace of technological innovation in Virginia, these factors are especially important in establishing GAAP lives for Verizon VA's depreciable assets.

Verizon VA also used benchmarking to assess the reasonableness of its depreciable lives. Benchmarking provides an external validity check to confirm that the results obtained from the internal process used to assess depreciable lives are consistent with lives obtained by competitors using similar technology and operating in similar competitive markets. For example, Verizon VA compared its depreciable lives with the lives used by its competitors, AT&T and WorldCom. Verizon VA also compared its depreciable lives to lives used by cable television operators, which use similar technology in providing their services. Verizon VA's benchmarking analysis shows that its proposed depreciation lives are consistent with (and in some cases longer than) the depreciation lives used by other carriers.

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[12] *Public Utility Depreciation Practices*, National Association of Regulatory Utility Commissioners (NARUC) at 15 (1996).

Finally, Verizon VA used TFI studies, which, as Mr. Sovereign explains, analyze the remaining economic lives of assets.

Q. Do Verizon VA's proposed depreciation lives follow GAAP principles?

A. Yes. Based on my review of Mr. Sovereign's testimony, I conclude that the factors Verizon VA considered in determining depreciation lives follow GAAP principles.

In addition, Verizon VA's financial statements – which include the depreciation lives proposed in this proceeding – have been audited by Ernst & Young, LLP. Ernst & Young issued an opinion letter stating:

> In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Verizon at December 31, 2000, and the consolidated results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

Importantly, the auditors' statement that the financial statements "present fairly . . . in accordance with accounting principles generally accepted in the United States" includes the depreciation expense and accumulated depreciation contained in the financial statements, as well as the disclosures relating to depreciation and depreciable lives contained in the notes to the financial statements.

Ernst & Young also describes the scope of the audit they conducted:

> We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting

principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

These statements include an evaluation of the material supporting depreciation lives.

IV. THE 1993 AND 1994 REGULATORY PRESCRIBED LIVES ARE OUTDATED AND DO NOT REFLECT TRUE ECONOMIC OR GAAP DEPRECIATION LIVES. (JDPL Issues II-1-a; II-1-c; II-2-a; II-2-c)

Q. Are the 1993 and 1994 regulatory prescribed depreciation lives consistent with GAAP or forward-looking costing principles?

A. No. The current depreciation lives prescribed for Verizon VA were prescribed in 1993 and 1994, prior to the passage of the Telecommunications Act. As a consequence, these lives are outdated and do not reflect the advancements in technology over the last six years or the effect of competition. Verizon VA witnesses Dr. James Vander Weide, Harold West III and Al Sovereign further explain in their testimony the risks and competition facing Verizon VA today in Virginia. These Virginia-specific factors demonstrate that depreciation lives set in 1993 and 1994 for regulatory purposes are inappropriate for establishing forward-looking depreciation lives in this proceeding.

Q. Why hasn't Verizon VA asked this Commission to review its depreciation lives since 1993 and 1994?

A. Verizon VA has had no reason to seek this Commission's review of its depreciation lives because, as Mr. Sovereign explains, it would have served no

useful purpose. While depreciation represcription may be relevant to rate of return regulation, it serves no purpose under the Commission's price cap regulation regime. The Commission now has the opportunity to consider recent Virginia-specific data, as provided in the testimony and report of Harold West III, in establishing appropriate depreciation lives.

V. CONCLUSION
(JDPL Issues II-1-a; II-1-c; II-2-a; II-2-c)

Q. In your opinion, which depreciable lives are the best forward-looking lives for establishing permanent UNE rates?

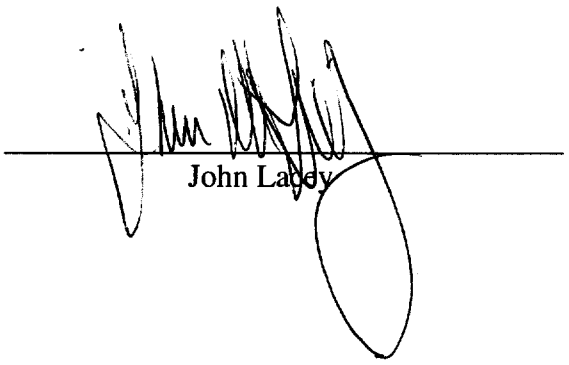
A. It is my opinion that Verizon VA's GAAP lives used in its financial statements are the best forward-looking depreciable lives for establishing permanent UNE rates. These GAAP lives best reflect the conditions facing Verizon VA in a competitive and rapidly changing market. These lives are entirely reasonable and unbiased, and fairly reflect the competitive market. Indeed, they are consistent with (and in many cases longer than) the lives used by Verizon VA's competitors. The 1993 and 1994 regulatory prescribed lives, in stark contrast, are outdated and do not reflect today's competitive market or the competitive market of the future.

Q. Does this conclude your direct testimony?

A. Yes.

Declaration of John Lacey

I declare under penalty of perjury that the foregoing is true and correct. Executed this 28th day of July, 2001.



John Lacey